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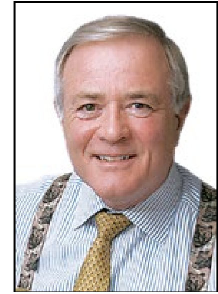
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OP-ED: The Fed vs. the market: Which one will have its way?

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As the Federal Reserve carried out its battle against inflation, consequences arose that were unintended: The banking system suffered the biggest bank failure in years. Silicon Valley Bank, a 40-year-old institution centered in Santa Clara, California, suffered a run and had to close. The failure was sudden. The bank had been wobbly for a brief time, but failed suddenly when a small, closely connected group of large depositors demanded their money in a classic "run on the bank."

The bank, thought to be well-capitalized, had to close upon revelation that it had a considerable amount of its assets invested in bonds, whose value had declined as interest rates rose. When interest rates were abnormally low, Silicon Valley Bank loaded up on long-term government bonds, which were thought to be risk free. When the Fed raised interest rates at the sharpest pace in 40 years, bond prices plunged and the bank's equity, when its assets were marked to market value, was wiped out.

The discovery of this caused venture capital funds to lose confidence in the bank's finances and instruct their portfolio companies, who were concentrated in Silicon Valley, to withdraw their money. Paper losses became real losses, as the bank had to sell bonds before maturity at a loss. So, what took 40 years to create disappeared in the blink of an eye, because of the bank buying long-term bonds to fund demand deposits. Apparently bank regulators had flagged this mismatch at the bank for some time, but that is all they did.

With the bank run, regulators acted quickly to sell the bank, but no buyers could be found. This startling news started a bank run contagion with problems that threatened to spread further in the banking system. More effort was needed before the panic spread to other banks and so the U.S. Treasury stepped in to backstop all the depositors, thereby saving thousands of companies and jobs. The shareholders of Silicon Valley Bank and Signature Bank – a New York City bank that failed at the same time – were wiped out.

The panic spread to Europe, where another bank, Credit Suisse, saw a run. That ultimately threatened the rest of Europe when it was discovered that not even the gnomes of Switzerland could avoid the loss of confidence in its fabled system. Finally, the Swiss government stood up and stopped the run by getting UBS to buy all of Credit Suisse. Only then was relative calm restored, but not before vast sums of money evaporated.

Rising interest rates had left the global banking system vulnerable. It was a stark reminder that the system is still subject to risks that were not appreciated by a new generation of investors and traders. It was a reminder how close the markets, reliant on confidence in the system, are to a sudden meltdown. Banking regulators stepped in to shore up the banks, both here and abroad. The effort worked, until the next time.

Jamie Dimon, CEO of JPMorgan Chase, the largest U.S. bank, said the damage from this meltdown will last a long time. A side effect of the bank run is a flight to quality. Deposits left small banks for large, well-funded banks, causing lost deposits in the small, regional and community banks. Could this ignite another bank failure? It might. It is too soon to know. Certainly, this shift of assets will decrease liquidity available to small businesses, which will curtail their hiring and investment plans and slow the economy further. Local banks know their customers and provide the capital for their expansion. Money center banks do not.

Investors learned many lessons from this banking imbroglio: No bond is risk free. Banks can fail. Bank deposit insurance has limits. It is wise for individuals and companies to pay attention to these limits and diversify one's deposits.

What is the Fed to do now? Lowering interest rates would be one solution, but the Fed is reluctant to do so in its fight against inflation for fear it would reignite inflation. Raising interest rates is what got us into this mess, so that does not appear a good alternative. Federal Reserve Chair Jerome Powell says that raising interest rates would cause a recession. The market appears to be doing the Fed's work as interest rates are sliding. Perhaps if we let the market do its work, we can get out of this mess. Our confidence is in the market.

What is an investor to do? It will come as no surprise that we recommend investing in a well-diversified portfolio for the long term. U.S. Treasury Secretary Janet Yellen said in a generally positive remark that the economy is strong, and inflation is abating. We have counted on her in the past. Can we count on her now?

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